

1997

Investment Interest Expense Deduction

3526

Attach to Form 540, Form 540NR or Form 541.

Name(s) as shown on return

Social security number or FEIN

| | | | |
|----|--|----|-------|
| 1 | Investment interest expense paid or accrued in 1997. See instructions | 1 | _____ |
| 2 | Disallowed investment interest expense from 1996 form FTB 3526, line 5. If zero or less, enter -0-. | 2 | _____ |
| 3 | Total investment interest expense. Add line 1 and line 2. | 3 | _____ |
| 4a | Gross income from property held for investment (excluding any net gain from the disposition of property held for investment) | 4a | _____ |
| 4b | Net gain from the disposition of property held for investment. See instructions | 4b | _____ |
| 4c | Net capital gain from the disposition of property held for investment. See instructions | 4c | _____ |
| 4d | Subtract line 4c from line 4b. If zero or less, enter -0-. | 4d | _____ |
| 4e | Enter all or part of the amount on line 4c that you elect to include in investment income. Do not include more than the amount on line 4b. See instructions | 4e | _____ |
| 4f | Investment income. Add line 4a, line 4d and line 4e | 4f | _____ |
| 5 | Investment expenses. See instructions | 5 | _____ |
| 6 | Net investment income. Subtract line 5 from line 4f. | 6 | _____ |
| 7 | Disallowed investment interest expense to be carried forward to 1998. Subtract line 6 from line 3. If zero or less, enter -0-. | 7 | _____ |
| 8 | Investment interest expense deduction. Enter the smaller of line 3 or line 6. Form 541 filers, stop here and see instructions. All other filers, go to line 9. | 8 | _____ |
| 9 | Enter the amount from federal Form 4952, line 8. | 9 | _____ |
| 10 | California investment interest expense deduction adjustment. Enter the difference between line 8 and line 9. See instructions. | 10 | _____ |

General Information

Due to California legislation enacted in 1997, California tax law conforms to the Internal Revenue Code (IRC) as of January 1, 1997, and to selected provisions of the federal Taxpayer Relief Act of 1997 (Public Law 105-34).

Specifically, for tax years beginning after December 31, 1992, under federal law, net capital gain from the disposition of property held for investment is excluded from investment income when figuring the investment interest limitation. However, taxpayers may elect to include as much of their net capital gain investment income as they choose if they also reduce the amount of net capital gain eligible for the special federal capital gain tax rate. California conforms to this federal provision for tax years beginning on or after January 1, 1997. This form has been revised to allow making a separate California election for including net capital gain investment income in the calculation of the investment interest limitation. However, California does not have a special capital gain tax rate (all income is taxed at the same rate), and you should consider the effect on your California tax before making a separate California election or applying the federal election for California purposes.

A Purpose

Interest expense paid by an individual, estate or trust on a loan allocable to property held for investment may not be fully deductible in the current year.

Use form FTB 3526 to figure the amount of investment interest expense deductible for the current year and the amount, if any, to carry forward to future years.

B Who Must File

If you are an individual, estate or a trust and you claim a deduction for investment interest expense, you must complete and attach form FTB 3526 to your tax return, unless **all** the following apply:

- Your only investment income was from interest or dividends;
- You have no other deductible expenses connected with the production of interest or dividends;
- Your investment interest expense is not more than your investment income; and
- You have no carryovers of investment interest expense from 1996.

Specific Instructions

Generally, California law for the investment interest expense deduction follows federal law. Get the instructions for federal Form 4952, Investment Interest Expense Deduction, for more information. Get federal Pub. 550, Investment Income and Expenses, to determine your investment interest expense deduc-

tion if you have interest income or expense attributable to a working interest in oil or gas property or if you paid or accrued interest on a loan and you used the proceeds of the loan for more than one purpose.

Line 1 – Investment Interest Expense

Enter the investment interest paid or accrued during the tax year, regardless of when you incurred the indebtedness. Investment interest is interest paid or accrued on a loan (or part of a loan) that is allocable to property held for investment. Include investment interest expense reported to you on Schedule K-1 (100S, 541, 565 or 568). Include amortization of bond premiums on taxable bonds purchased after October 22, 1986, but before January 1, 1988, unless you elected to offset amortizable bond premiums against the interest payments on the bond. A taxable bond is a bond on which the interest is includible in gross income.

Investment interest expense does not include:

- Home mortgage interest;
- Interest expense that is properly allocable to a passive activity (see "Passive Activities" on Side 2);
- Any interest expense that is capitalized, such as construction interest subject to IRC Section 263A; or
- Interest expense related to tax-exempt interest income under R&TC Section 17280.

Property Held for Investment. Property held for investment includes property that produces investment income. However, it does not

include an interest in a passive activity. See "Passive Activities" below for more information.

Property held for investment also includes an interest in an activity of conducting a trade or business in which you did not materially participate and that is not a passive activity. For example, a working interest in an oil or gas property that is not a passive activity is property held for investment if you did not materially participate in the activity.

Passive Activities. A passive activity is any business activity in which you do not materially participate and any rental activity regardless of your level of participation. Investment interest expense does not include any interest expense that is included when determining your income or loss from a passive activity. However, interest expense that is properly allocable to portfolio income is investment interest expense and is not included when determining your income or loss from a passive activity. Portfolio income includes income (not derived in the ordinary course of a trade or business) from interest, dividends, annuities, royalties and net gain from the disposition of property held for investment. Beginning in 1994, and for federal purposes only, rental real estate activities conducted by persons in a real property business are not automatically treated as passive activities. California did not conform to this provision. For more information about passive activities, get the instructions for federal Schedule E, Supplemental Income and Loss.

Line 4a – Gross Income from Property Held for Investment

Gross investment income includes income (not derived in the ordinary course of a trade or business) from interest, dividends, annuities and royalties. Net income from the following passive activities is also treated as investment income:

- Rental of substantially nondepreciable property;
- Equity-financed lending activities; and
- Acquisition of certain interests in a pass-through entity licensing intangible property.

Also include on line 4a (or line 4b, if applicable) net passive income from a passive activity of a publicly traded partnership (as defined in IRC Section 469(k)(2)) and investment income reported to you on Schedule K-1 (100S, 541, 565 or 568).

Line 4b

Net gain from the disposition of property held for investment is the excess, if any, of total gains over total losses from the disposition of

property held for investment. When figuring this amount, include capital gain distributions from mutual funds.

Line 4c

Net capital gain from the disposition of property held for investment is the excess, if any, of net capital gains over net capital losses from the disposition of property held for investment. When figuring this amount, include capital gain distributions from mutual funds.

Line 4e

Net capital gain from the disposition of property held for investment is excluded from investment income. However, you may elect to include in investment income all or part of the net capital gain from the disposition of property held for investment. You must make the election no later than the due date (including extensions) of your California income tax return. Once made, the election may not be revoked without the consent of the Franchise Tax Board.

To make the election, enter all or part of the amount on line 4c, but not more than the amount on line 4b, that you elect to include in investment income.

Line 5 – Investment Expenses

Investment expenses are your allowed deductions, other than interest expense, directly connected with the production of investment income. For example, depreciation or depletion allowed on assets that produce investment income is an investment expense.

Include investment expenses reported to you on Schedule K-1 (100S, 541, 565 or 568).

Investment expenses do not include any deductions taken into account in determining your income or loss from a passive activity.

If you have investment expenses that are included as a miscellaneous itemized deduction on federal Schedule A (Form 1040), line 22, you may not have to use the entire amount for purposes of form FTB 3526, line 5. The 2% adjusted gross income limitation on federal Schedule A, line 25, may reduce the amount.

To figure the amount you may use, compare the amount of the investment expenses included on federal Schedule A, line 22, with the total miscellaneous expenses on federal Schedule A, line 26. The smaller of **(a)** the investment expenses included on line 22 or **(b)** the total of line 26 is the amount of investment expenses included as a miscellaneous itemized deduction to use when figuring form FTB 3526, line 5. If you made adjustments to

your miscellaneous expenses on Schedule CA (540 or 540NR), California Adjustments, be sure to include the adjustments in the calculation.

If you have investment expenses reported on a form or schedule other than federal Schedule A, include those expenses when figuring investment expenses for line 5.

Line 8 – Investment Interest Expense Deduction

Form 541 filers should enter the amount on line 8 as a deduction on Form 541, line 10. All other filers must complete line 9.

At-Risk Activities. If any portion of the deductible investment interest expense on line 8 is attributable to an activity for which you are not at risk, you must also complete federal Form 6198, At-Risk Limitations, (using California amounts) to figure your deductible investment interest expense. Get federal Form 6198 and instructions for more information.

After you figure the allowable investment interest expense on form FTB 3526, enter the portion attributable to the at-risk activity on federal Form 6198, line 4. Reduce form FTB 3526, line 8 by the same amount.

Refer to federal Form 6198 and its instructions for more details, especially the instructions for line 4 of that form.

Line 10 – California Investment Interest Expense Deduction Adjustment

The amount on line 10 is the difference between the deduction allowed by California and the deduction allowed under federal law.

If line 8 is larger than line 9, subtract line 9 from line 8. Enter the result as a positive amount on line 10 and on Schedule CA (540 or 540NR), line 37. Be sure to write "FTB 3526" on Schedule CA (540 or 540NR), line 37.

If line 9 is larger than line 8, subtract line 8 from line 9. Enter the result as a negative amount on line 10 and on Schedule CA (540 or 540NR), line 37. Be sure to write "FTB 3526" on Schedule CA (540 or 540NR), line 37.

Note: If any portion of your investment interest expense on line 8 is attributable to royalties, enter the difference between the California and federal amounts on Schedule CA (540 or 540NR), line 17, column B or column C as appropriate.

Alternative Minimum Tax (AMT). Deductible investment interest expense is an AMT adjustment. Get Schedule P (540, 540NR or 541), Alternative Minimum Tax and Credit Limitations, for more information.